ECONOMICS

LESSON 14

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ECONOMICS

LESSON XIV.

Profits.

IN the present lesson we have as our subject the last of the four shares in the distribution of wealth—Profits. This is the share which remains in the hands of the entrepreneur after he has compensated landlord, capitalist and laborer for the use of their land, capital and labour respectively. In dealing with this subject it is well first to consider what sort of people receive profits and what are the services which they render to society in return.

Who are entrepreneurs?

What is an entrepreneur? The word has been borrowed from the French and, literally translated, is equivalent to "undertaker"—one who undertakes the management of a business, who takes the chance of success or failure, who gains if he manages his business well and loses if he manages it ill. Besides these gains or losses due to his own ability the entrepreneur is also liable to incur losses arising from causes altogether outside of his own control, but due to the chances of business—an over-supply of his wares on the market, "tight" money which compels him to pay more than he has expected for his capital, or labour troubles which force him to pay more wages than he has calculated upon. He has, on the other hand, corresponding possibilities for gain—a market understocked with his wares, a chance to obtain "easy" money, which will enable him to make larger profits, and a supply of cheap labour.

The word "entrepreneur" has sometimes been translated "undertaker," sometimes "enterpriser," sometimes "captain of industry," though this latter translation is misleading in that it seems to imply command over numbers of wage-earners, whereas, as a matter of fact, the entrepreneur may be and often is the captain only of his

own pair of hands. Anyone who is the responsible manager of a business is an entrepreneur. A limited liability corporation engaged in business is also an entrepreneur, since it carries on business and takes the risk of gain or loss.

The Entrepreneur in Agriculture.

Thus, then, our "farmer" is an entrepreneur, even though he has no hired man. Altogether apart from his manual labour, it is his business to consider the markets for his products and to sell to the greatest advantage, and it is also his business to consider the various kinds of soil at his disposal and to decide what crops can best be grown upon these different soils and what rotation of crops he will pursue. In Ontario alone there are estimated to be 175,000 farmers, and we thus have 175,000 entrepreneurs.

So too in industry. A repairing cobbler, a barber, and a Chinese laundryman are just as much entrepreneurs as is the Canadian Pacific Railway Company with its 70,000 employees or the Massey-Harris establishment. The important distinction lies not in the size of the business, but in the fact that it is a unit operating independently.

Even where the four functions—those of the landlord, capitalist, wage-earner and entrepreneur—are all performed by one person, it is possible to estimate approximately the return accruing to the individual under each of the four heads. Thus, for example, take the case of the average farmer who owns his farm and the buildings and stock thereon. The average annual product of the Ontario farm is estimated by the Ontario Department of Agriculture as being worth \$2,000. Now, let us assume that this average farm is cultivated by the labour of one farmer, with the assistance of one hired man for the seven or eight months of the agricultural season. The farm land is worth, let us say, \$3,000; buildings, fences, etc., \$3,000; stock and implements necessary to cultivation, \$2,000. Let us suppose money to be worth 6%. Our farmer's income after allow-

ing say $300 for the hired man's board and wages will be about $1,700. This may be divided roughly as follows:

As landlord, say 6% on $3,000	$180
As capitalist, say 6% on $3,000+$2,000	300
As wage-earner* (including labour of family) say	720
As entrepreneur, say	500
Total income	$1,700

The great differences which we see in the condition of our farmers are, of course, due partly to the fact that some have much greater capital than others, but they are also due to the fact that some farmers earn practically nothing as entrepreneurs, are indeed such failures in this respect that they do not earn so much when working for themselves as they would if they worked for someone else. Other farmers are skilful entrepreneurs, and perhaps on a farm similar to that which we have described, will earn $1,000 or more instead of $500 for the entrepreneur's part of their work. The annual extra $500 is then presumably saved and added to capital, giving its owner opportunity to carry on his enterprise on a larger scale and thus increase his income. These two classes of men are popularly known as "good managers" or "bad managers."

If the ability as an entrepreneur—the business ability—of our farmers could only be increased, there is no doubt that their product could be much augmented without any additional burden of hand-labour. The difficulty is to make 175,000 farmers skilful entrepreneurs.* Business

*The farmer's income as wage-earner is here understood to be equal to what he and his family could earn if they were working for someone else. His own value as a wage-earner might possibly be reckoned lower, say at $500.

*As we have noted in a previous lesson, large-scale production does not obtain to any considerable extent in agriculture. There are more entrepreneurs (farmers) in agriculture than wage-earners who are not entrepreneurs (hired men). In manufactures there are many more employees than employers.

ability and business education are not common enough for us to make so large a percentage of our population good business men. However, there is no doubt that the farmer's skill as entrepreneur, and indeed the skill of business men generally, is increasing and is enabling them to obtain better results with less actual manual labour than formerly. The chief work of our model farms and our Departments of Agriculture is to make our farmers better entrepreneurs, to enable them to get better results from a given expenditure of effort.

While the entrepreneur is, in so many cases, the same person as the wage-earner, there is in the business world particularly an increasing tendency for him to be differentiated from the wage-earner. This is due to the increasing specialization of function in industry, and is inevitably the case in large scale production. Such production is to-day carried on mainly by corporations.

The Entrepreneur in Corporations.

In limited liability corporations the shareholder partakes of the functions of capitalist and entrepreneur. He resembles the former in having an investment of so many dollars in the company, the latter in being the ultimately responsible entrepreneur, though at the annual meetings he delegates the active work of managing the business to the president and board of directors and indirectly to the general manager employed by them. The shareholder, however, cannot delegate his profits and losses to someone else. He is the person to whom the gains accrue and who incurs the losses incident to the enterprise, while the bondholder who lends money to the company is the pure capitalist who gets his interest on his capital whether the shareholder gets anything or not.*

*Of course this argument does not imply that the bondholder never incurs loss. He lends to the corporation on the security of its property and earning power. His position is like that of a mortgagee, and it is possible that his advances may exceed the value of the security, especially if this is decided by forced sale at an inopportune time. He is only relatively not absolutely secure against loss.

If we wish to find out just how much the profits of a share are as distinguished from the interest, we may compare the rate of dividend received by the shareholder and bondholder, say 7% and 5% respectively. Then the extra 2% is profits as distinguished from interest, and to this may be added that part of the increased reserve which accrues to a single share—the undivided profit, as it is called. Suppose that is 1%. Then the shareholder's net profits are 3% in what we may call a fairly good year. In a very poor year, not only may the net profits be nil, but the dividend may be "passed" altogether, and thus the shareholder will receive nothing whatever for the use of his capital, and may be said to incur a loss of [illegible]% on his capital since as a bondholder he might have received this amount.

Profits the Residual Share in Distribution.

Profits is sometimes said to be the residual share of the product of industry. This implies that it is the last share. The other shares are, over a short period of time, at least, fairly well fixed. The entrepreneur knows how much rent he will have to pay, he knows how much interest he will need to pay for the use of his capital, he knows approximately how much he is likely to have to pay in wages, and he is able to calculate with some degree of accuracy the cost of his raw material and the selling price of his finished product. If, then, he goes into business under such circumstances, it is fairly obvious that he does so because he feels that the net product with rent, interest and wages deducted will still leave him a sufficient return for his labour in doing business and organizing the work of production. He may quite easily be wrong in his calculations. Conditions may change so that his profits may be much greater or much less than he had anticipated. Even the most skilful entrepreneur may find himself financially straitened and producing at a loss.

Why should this be the case? In production there are several varying factors whose course can be only approximately predicted. The entrepreneur must, in the case of

most manufacturers, produce his goods six months or a year before they are likely to be sold. He takes a chance on the state of the market at that time and all the capital he has tied up in his manufactured goods, buildings, machinery, etc., is staked on the correctness of his judgment. Many conditions which it was quite impossible to foresee may arise. As the poet Burns expresses it:

> " The best-laid schemes of mice and men
> Gang aft agley."

The Three Elements in Profits.

Profits, as analyzed by economists, appear to consist of three constituent parts:

(a) Wages of management.
(b) Ordinary gain and loss.
(c) Monopoly gains.

Wages of Management.

The wages of management, a return for assuming the labour and burden of management. This element tends to equal the amount which the entrepreneur would get if he were employed as manager at a fixed salary. Some economists prefer to classify this under the head of wages. The entrepreneur must, in the average case, earn at least as much as an entrepreneur as he would if he were working as a wage-earner for someone else. If he did not do so, he would hardly prefer the anxiety and worry of carrying on a business where he was responsible for everything, to the more mechanical and less exacting labour of the average wage-earner. The entrepreneur must keep his business in mind all the time, he must be continually planning new economies of material and of labour. He must study his markets with an anxious eye, carefully trying to anticipate the course of events which may increase or diminish the return from the sale of his products. Since human nature is as it is, the average human being will not do all this unless he can secure a sufficient reward for his labour, though there is no doubt that some people

are ready to accept even less as entrepreneurs than they might get as wage earners, both because they prefer the comparative independence of this position and because they expect that a favorable turn of the market may bring them in a prize which will more than make up for their previous privations.

Ordinary Profit and Loss.

The second element which enters into profits is the gain or loss resulting from the risks inevitable in industry. Not only is there uncertainty in undertaking a new industry, but the more or less extended period of time required for production leaves the established industry subject to the risks arising from chance or uncertain events.

The risks which the average entrepreneur in business takes in modern industry are enormous—greater than the entrepreneur recognizes—though they are no doubt mitigated when the entrepreneur plays in addition some one or more of the other three roles—is landlord, capitalist or wage-earner. Such a man may earn in some of the other capacities enough to maintain himself until fortune smiles upon his efforts as entrepreneur. The risk is also less in the case of an entrepreneur who sets to work to produce a necessity of life, than in that of one who produces a luxury for which the demand may be entirely artificial and may fall away altogether in bad times. But in every case there are risks—risks many and various which no effort of human prudence could foresee. It may be worth while to refer to some of these.

(1) In the first place, there may be distress due to a general depression of trade, owing possibly to a failure of the crops. This may so restrict the demand for the entrepreneur's goods that he may have to sell his product at cost or under cost in order to secure money enough to pay wages, interest and rent. In spite of trouble and worry, in spite of all human diligence, he may find his profits just nothing at all.

(2) Again, a sudden stringency in the money market,* due possibly to wars and rumours of wars, may cut off his supply of cheap running capital which he receives from banks, and this may compel him to close up operations altogether or to sell his products at a sacrifice in order to get money to meet his engagements.

(3) There may be a shortage or entire stoppage in the supply of raw material, as when the English cotton factories had to shut down at the time of the American Civil War, because the northern war-vessels blockaded the southern ports.

(4) There may be a falling off in the demand for his particular product, due to change in the fashions or habits of a people. This occurred some years ago in the bicycle industry.

(5) The adoption of improved and more economical methods of manufacture by large scale producers may drive the small entrepreneur to the wall. He may not have the money to introduce the new machinery, even though he may have the ability to see its advantage. Or he may have both money and ability, but not have a sufficiently large product to make the new machines pay. "The International Harvester Company," says Taussig, "has a machine whose sole work is to shape poles for wagons and harvesters. The machine cost $2,500; it saves a cent per pole; it is worth while only because poles by the hundred thousand are made every year." A former lesson dealt with the advantages of large-scale production; every advantage of large-scale production is a disadvantage for the small entrepreneur who is not able to produce on a large scale. It is only where large-scale production has shown no preponderating advantage over small-scale production, as is the case in agriculture and retail selling, that small entrepreneurs have survived in great numbers.

*A notable instance of this occurred in the winter and spring of 1912-1913.

Monopoly Profits.

The third element in profits is known as monopoly profits, which is an acquisitive gain due to superior bargaining power resulting from monopolistic conditions. For example, monopolistic conditions may allow the charging of higher prices for products, the paying of lower prices for materials, the control of labor supply, the acquisition of special privileges from public and semi-public bodies, such as low taxation, railway rebates, etc.

If one entrepreneur has a monopoly of a certain product, or of a certain service, he will usually be able to secure a higher price than would be possible under competition. His cost of production—his material, his rent, his interest, and his wage-payments—would be in no way increased, but rather reduced through his possession of a monopoly. Consequently, both by reason of higher selling prices and lower cost of production, his profits would be greater than under competitive conditions: they would contain a monopoly element.

A good example of this profit is found in the case of street railways, which often secure an exclusive right to run cars in a certain city for so many years. Then they proceed to reckon this franchise as an asset at a figure equivalent to the capitalized value of the monopoly profits as distinguished from other profits. The judges in Michigan allowed the Detroit Street Railway to reckon its franchise at $8,000,000, and issue capital stock for that amount in excess of actual investment, which means, if we reckon profits at 5%, and if the franchise was perpetual, that the monopoly profits of this concern were $400,000 per annum.*

*Enterprises competing for trade in a certain district, and earning fair profits often agree to merge themselves into a larger corporation in order to obtain a monopoly. In such a case the amount of stock and bonds issued by the new corporation is practically always far in excess of the combined stock of the constituent companies. The excess represents in the main the capitalized value of the prospective monopoly profits. See the list of Canadian mergers and amalgamations published in the 1913 edition of the Monetary Times Year Book.

Insurances Against Entrepreneur's Risks.

The entrepreneur's position involves many worries. He has many risks of many kinds to face. Some of them may be foreseen; others are purely fortuitous; yet either kind may ruin him. It is no wonder, then, that most entrepreneurs are willing to insure themselves in one way and another against many of the risks incident to their business. Thus one partner may insure another's life in order to protect the firm against withdrawal of capital consequent on the other's death. So, too, entrepreneurs insure their places of business and their stock against fire.

Other kinds of insurance against loss are almost as common as the foregoing. One interesting type is the insurance against having to pay too high rates for raw material, or against receiving too low rates for finished product. The entrepreneur contracts to receive from the producer of raw material a certain quantity of his product for a certain time at a certain fixed price, regardless of what the market price may be. The producer agrees to sell that quantity at that price. Thus the entrepreneur eliminates one element of risk in the situation.

A builder wishes to construct houses to sell at $5,000, involving at present prices an expenditure of $4,500. He fears an advance in the price of materials before his contract can be completed. He can buy brick at $12 a thousand, but the trend of prices is upward, and if they advanced $3 per thousand his profit would be eliminated. Owing to a shortage of his funds, or to a shortage in the supply of brick, he cannot at once secure all he will need. Accordingly, he goes to the brickmakers and offers them $13 a thousand for a sufficient number of bricks to complete his contract. He sacrifices one-third of his profit in order to insure himself against the possibility of having to sacrifice it all.

Risks Least in New Countries.

The entrepreneur has, on the whole, a better chance of making his way and earning profits in a new country than in an old. There is in the new country freer land and

greater natural resources, which contribute to a greater per capita production of wealth, and there is also a large annual addition to the population through immigration. This means to the business man an increased number of customers. Fairly competent entrepreneurs are thus able to do a good business and make money. The struggle for existence does not assume the same bitterness and intensity that are evident in older countries.

In the new countries, therefore, many entrepreneurs have become exceedingly wealthy through the difference between the cost of production and the prices which they are able to secure for their products.

Profit-Sharing.

The amount of profits earned by an entrepreneur—the difference between the total cost of production and the price which he is able to secure for his products—necessarily depends very largely upon the efficiency of his staff of wage-earners, their good-will, and the energy which they throw into their work. In dull times an entrepreneur will often continue to produce at a loss rather than close down his operations and allow his staff to be scattered abroad. He does this because he realizes that if his staff were dispersed it would take much time and trouble and expense and training before an equally efficient staff could be brought together. Clearly, then, he recognizes his staff as one of the productive assets of his business—one of the means through which he secures his profits.

The Occasional Bonus.

Since this is his feeling, it is not at all wonderful that at Christmas, or at the end of the year, an employer who has earned large profits, and who feels that his staff have worked hard for him, should decide to give them a bonus in addition to their pay, as a reward for their diligence in the past and an encouragement to similar industry in the future. He may do this partly from generosity and partly form policy, believing that his staff will be so stimulated

by the bonus that they will work with even greater industry in future, and will thus more than recoup the employer for his expenditure on the bonus.

The granting of a bonus such as is given in some of our banks marks the initial step in what is known as profit-sharing. The granting of the bonus is a matter of grace on the part of the employer; the employee has no right to look forward to it, and no claim upon the employer for it. At the same time, if it goes on year after year, it will gradually become almost a fixed institution of the business, and the employees would feel aggrieved if deprived of it.

Regular Profit-Sharing.

Some employers have been willing, therefore, to regularize the situation—to guarantee to the employees, in addition to ordinary wages, some definite share of the profits, thus making the bonus no longer a matter of individual caprice, but a regular payment of an amount correspondent to the general state of their business. Many differing schemes of this kind have been adopted. A few of these are worth our attention.

One method of profit-sharing is for wages and interest on capital to be paid out at the prevailing market rates, and any surplus to be divided equally between employers and employees. (Briggs colliery in England.)

Another arrangement is that the same rate of dividend shall be paid on wages as on stock. Thus, a man earning $600 a year would, in a year when the dividends paid were 10%, secure a bonus of $60 as his share of the profits. Sometimes this bonus is paid to the worker in cash; sometimes it is invested for him in the stock of the corporation, and he becomes entitled to the same rate of interest on it as the other shareholders receive. In one or two cases this policy has resulted in the workmen securing the majority of the stock and thus becoming the masters of the establishment.

Advantages of Profit-Sharing.

Profit-sharing has, in most cases, had its advantages, both from the side of him who gives and him who takes—the employer and the employee. The employer gains through having a more devoted, a more efficient, and a more permanent staff than he could otherwise secure, since usually a share in the profits is distributed only to employees who have spent a specified time with the firm.

The employee gains through having a higher wage.* He is also a gainer through the increased industry and self-respect which the feeling of a partnership in the concern gives to him. Most employers insist on their employees speaking of the firm as "we," wisely believing that a man who speaks of his firm as "we" will do more for it than one who says "they" or "the boss." Surely, if the mere word which implies co-operation is of value to a business, the actual thing itself must be of much greater value. The psychological attitude of the wage-earner is of great value to both his employer and himself.

Defects of Profit-Sharing.

The main weakness of profit-sharing is the uncertainty of profits. The efficiency and devotion of employees has, no doubt, much to do with the earning of profits, but even these may fail to earn profits in a bad season, and where no profits are earned none can be shared. The workers will then become suspicious of the employer's good faith, and it is only too probable that the whole profit-sharing arrangement will fall to the ground.

The dominant opinion of the wage-earner to-day is that of the trade union. Now, the union dislikes profit-sharing, as tending to separate workmen from their class and bind them to the employer. It interferes with "class solidarity," interferes, the union claims, with the "manly in-

*Trade union leaders sometimes maintain that profit-sharing firms do not pay the average rate of wages, in which case, of course, no real profit-sharing takes place, so such firms are not considered profit-sharing industries.

dependence of the workers" and makes them more subservient to the employer.

It is only the exceptional employer who will be able, by his personal qualities, to dispel such suspicions, to gain the confidence of his employees, to make them feel that he is genuinely anxious for their welfare as well as for his own, without relapsing into that patronizing attitude which is obnoxious to the workers of to-day. Thus, while profit-sharing may be successful and productive of much good in individual cases, it can hardly be expected that it will ever become a general method of improving the condition of the great wage-earning class. Other attempts at the solution of this problem will be treated in the next lesson, which will deal with Labour Problems.

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Profit-sharing experiments in Canada have been comparatively few. An important experiment in profit-sharing is thus described in the "Labour Gazette" for June, 1911:

"A profit-sharing scheme in force in the establishment of Messrs. W. J. Gage & Co., manufacturing stationers and publishers, of Toronto, Ont., is stated by the firm to be not only greatly appreciated by the staff, but to be of real service to business. . . . . .

"For the purposes of profit-sharing, the staff is divided into two classes, viz.: heads of departments and employees. A block of the capital stock of the company was transferred to the president, who, in turn, allotted to each of the heads of the departments a certain amount of stock, the amount varying with the experience and length of service of the beneficiary. The transfer was made under an agreement between the president and each individual concerned, by which the first charge on the dividend declared on the stock is that of reasonable interest on the stock remaining unpaid. The remaining portion of the dividend, after paying this interest, is then applied on the purchase of the stock, together with such further sums as the beneficiary may desire to apply.

"If in any year no dividend is declared by the company, no interest shall be charged, and if in any year the dividend falls below the rate fixed for interest, the dividend shall be regarded as paying interest in full. The agreements are for a term of ten years, at the end of which time the entire stock, or such as has been fully paid for, becomes the property of the beneficiary. Should the beneficiary die or leave the service of the company, it is then the president's privilege to buy back the stock, paying for it the full amount paid in by the beneficiary.

"For the benefit of the employees who are not provided for by the above arrangement, it has been the custom of the firm for a number of years to distribute among those who have been continually in their employ for at least twelve months a percentage of the profits earned. This distribution is based on the wage or salary of each employee."

EXAMINATION QUESTIONS

ECONOMICS.

LESSON XIV.

1. Define the functions of the entrepreneur.

2. Explain how the functions of the entrepreneur are divided in modern corporate industry.

3. From the purely economic point of view, is it wise for the farmer to spend all his time in manual labour? Explain.

4. "The entrepreneur is the residual claimant of the product of industry." Explain carefully.

5. Give instances taken from the actual business world in which profits are to be regarded as essentially:

   (a) wages of management;
   (b) the result of the success of a risky enterprise;
   (c) due to monopoly of the sale of the product.

6. A promoter buys up various street railway lines, forms a new company, which is greatly over-capitalized, and sells the stock at a gain. Is the gain profit, and if so, what kind of profit?

7. "Monopoly profits are more likely to be permanent than competitive profits." Discuss.

8. What economic advantages are likely to accrue to an employing entrepreneur from the introduction of a profit-sharing scheme? Describe different schemes in operation.

9. Are labour unions likely to look with favour upon profit-sharing? Why?

10. Do you expect that profit-sharing will become common in this country? Discuss.